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UNDP engagement in direct budget support and pooled funds

Summary

This paper is to provide UNDP country offices with policy and procedural guidance on UNDP engagement in a direct budget support and pooled fund environment. UNDP will not contribute to *general* budget support. The preferred value-added contribution of UNDP will be to support national capacities to negotiate, design and manage direct budget support for development effectiveness. UNDP will manage a sector or programme-based pooled fund on behalf of the government and donors, should the organization be called upon to do so in a transition phase. A primary focus of the pooled fund results would be national capacity development. UNDP will consider carefully the risks of transferring UNDP resources into a sector budget support fund managed by government or a pooled fund managed by a United Nations fund, programme or specialized agency. UNDP will provide such financial contribution based on the volume caps specified and the risk assessment and management criteria provided. UNDP will *not* transfer monies into a pooled fund not managed by a United Nations specialized agency, fund or programme.

Elements of a decision

The Executive Board may wish to: (a) welcome the engagement of UNDP in direct budget support and pooled funds; (b) encourage UNDP to pursue this approach with the United Nations Development Group (UNDG) to ensure synergy and common approaches to direct budget support and pooled funds; (c) endorse 2008-2011 as a pilot period for enabling UNDP financial contributions to direct budget support and pooled funds in the areas of the mandate of UNDP, within the limitations and provisions provided in the present report; and (d) agree to the addition of a financial regulation specific to direct budget support and pooled funds that would allow for the co-mingling of funds; and (e) request that the results of such be reported to the Board at the end of the pilot period, and that the financial report on contributions to direct budget support and pooled funds be included in the annual review of the financial situation.

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I. Introduction

1. UNDP recognizes direct budget support as a development finance instrument that promotes national ownership, transparency and harmonization in aid allocations, and alignment with national budget priorities. UNDP should use its mandate and comparative advantage to support national capacities, at all levels, to negotiate, manage and utilize direct budget support for development results. While acknowledging that direct budget support is not the core business of UNDP, this financing modality embodies principles of national ownership that UNDP has long stood for and that are called for by the Millennium Summit (2000), the Monterrey Consensus on Financing for Development (2002) and the Paris Declaration on Aid Effectiveness (2005).

2. The position paper on sector-wide approaches of the United Nations Development Group (UNDG) issued in February 2005 presents key guiding principles that this process is based on, as follows: develop more operational guidance for United Nations country teams; where necessary, amend existing legislation, rules and procedures so as to allow UNDG members to contribute, subject to approval by their respective governing bodies; and commit to United Nations country team support to national capacities to manage sector-wide approaches. It is important that the UNDG be well aligned, in this respect, with a harmonized policy and operational approaches. The UNDP policy and approach as stated here is aligned with that of UNFPA, which is the only other UNDG Executive Committee entity that has so far put forward a formal policy on this subject, with its Executive Board decisions in 2000 and 2002 supporting engagement in sector-wide approaches and basket funds.

3. Today, there is increased interest among a group of programme country governments and donors in using direct budget support, as one financing modality available to them, to provide, monitor and manage development finance directly through national budgets. The theoretical underpinnings of direct budget support follow those of poverty reduction strategies and the aid effectiveness agenda, and emphasize government ownership and donor alignment for greater aid effectiveness and hence a greater positive impact on poverty reduction. The Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) estimates that direct budget support will provide up to one-third of total aid flows in the immediate future. In some countries in the Africa region, it was already close to 30 to 40 per cent of total aid flows in 2004 (see OECD/DAC on Uganda, Tanzania, Zambia, Malawi, Mozambique, Ethiopia, Kenya, South Africa). However, little hard data has been published to date on direct budget support, so a real-time aggregate picture of aid flows through direct budget support is as yet unavailable. Given the somewhat recent focus on this modality, the long-term impact of direct budget support would have to be analysed through an evaluation of development results over time. What is evident is that direct budget support is an aid modality that serves to diversify development financing instruments available to programme country governments and donors for their use and review (see, for example, the current diagnostic of development financing trends and instruments provided by Sagati, Bezanson and Prada, 'The Future of Development Financing: Challenges and Strategic Choices', for the Swedish International Development Cooperation Agency, May 2005).

4. The litmus test for a country's preparedness to absorb direct budget support in transparent, efficient and results-oriented ways centres around the capacities of

national institutions, aid coordination mechanisms and management systems to negotiate, manage and monitor the use of such funds for their agreed purposes. Often of specific concern are the lack of a clear, well-tracked results framework, and of internationally recognized norms and standards for accounting, procurement and other business procedures; insufficient parliamentary oversight on budget allocation and use; inadequacies in public financial management; and the absence of multi-stakeholder accountability mechanisms to guide and review development results. A capacity development focus to these issues is therefore central to the contribution that the United Nations and UNDP can, and must, bring to the table. And that is better done by being an integral part of the direct budget support dialogue and support arrangements rather than being conducted as an add-on or separate process. This is in keeping with the Triennial Comprehensive Policy Review (resolution 59/250), where the United Nations system is asked to "support national capacities for the management of various aid modalities, including system-wide approaches and budget support".

5. The present report responds to a growing demand from programme country governments that UNDP look more closely at its overall engagement in direct budget support, which is now also a key part of the national policy dialogue and consultation processes on development effectiveness and aid coordination.

II. Definitions

6. Direct budget support is defined as a method of financing the budget of a partner country through a transfer of resources from an external financing agency to the national treasury of the partner government. The funds thus transferred are managed in accordance with the budgetary procedures of the recipient. This includes using the national regulatory framework for financial allocations, procurement and accounting systems (see also 'Harmonizing Donor Practices for Effective Aid Delivery: Budget Support, Sector-Wide Approaches and Capacity Development in Public Financial Management', OECD, 2005).

7. Direct budget support can take different forms. It can be classified into (a) general budget support, which is a non-earmarked contribution directed at overall government policy and expenditures, and includes balance of payments support; and (b) sector budget support, which is an earmarked contribution to the national budget towards sector or thematic programme-specific results.

8. It is important to distinguish sector-wide approaches from direct budget support. A sector-wide approach refers to the harmonization process of a sector and the programmatic approach taken, but not necessarily to the modality of financing. A sector-wide approach can be financed through a mix of sector budget support and project funding among others (see OECD 2005; and UNDG note on 'The Role of the United Nations in Sector-Wide Approaches', January 2005).

9. The present report uses the term *sector budget support fund* to refer to monies that go into the government budget, managed in a national account by a government entity for a specific set of sector or programme results. In the context of direct budget support, UNDP will only consider financial contributions to a sector budget support fund. The present report therefore focuses primarily on sector budget support rather than on the broader context of direct budget support.

10. *Pooled funds*, sometimes called basket funds, are designed for financing expenditures within a sector or a programme through the pooling of the financial

resources by the participating partners. The term pooled fund is used here to differentiate it from sector budget support (which consists of funds within the national account, managed directly by government). A pooled fund would be contracted out by government to be managed by an agreed party. Such pooled funds often play the role of an intermediate step, where donors are not able or willing to put money directly into the sector budget support fund of the government, or they view the pooled fund as more results-driven and effective at a given moment in time. A pooled fund would be used to support a sector-wide approach or a thematic programme.

11. Whether they flow directly into the national budget through sector budget support, or into a pooled fund, the monies contributed are *co-mingled* with non-UNDP funding sources and are directed towards a common set of results.

III. Policy and procedures for UNDP engagement in direct budget support and pooled funds

12. UNDP will not engage in general budget support, which is a general transfer to the national budget, since that is not its value-added role. The UNDP strategic plan, 2008-2011, defines the core contribution of the organisation as national capacity development.

13. In environments where government endorses the use of direct budget support and government and donors agree on the type of direct budget support modality that best fits the development cooperation need in that particular context, UNDP support in a direct budget environment can take the form of (a) a capacity development initiative and policy advisory services through a standard UNDP project, or (b) a UNDP financial contribution to a sector budget support fund or to a pooled fund. Alternatively, it could be a combination of (a) and (b).

14. An emphasis on supporting the joint analysis, planning and programming to deliver against national development outcomes, with complementary support to joint outcome monitoring and evaluation at the country level, underpins this effort.

15. The niche and support of UNDP will be focused very much on national capacity development in this context, and in two ways: (a) the capacities of the national entities negotiating, managing and overseeing sector-wide approaches in UNDP mandate areas; and (b) guiding these sector-wide approaches to focus more on national capacity development, so that support to national capacities is not an add-on or separately supported item in that sector/programme approach. Based on demand, the areas of capacity development emphasis in this context are:

(a) National policy analysis capacities;

(b) Negotiating sector-wide approaches: memoranda of understandings, policy matrices, management arrangements;

(c) Supporting national aid coordination mechanisms, whether inter-ministerial or sector based;

(d) National legislative and implementation capacities of anti-corruption and oversight bodies;

(e) State-citizen review and independent monitoring mechanisms;

(f) Strengthening national procurement, project and financial management capacities; and

(g) Strengthening national bodies and standards on auditing and results based reporting.

16. UNDP support for national capacity development, for government to coordinate, manage and implement direct budget support would be carried out in accordance with standard UNDP programme and project arrangements.

17. If it is decided that UNDP funds are not best directed into the sector budget support or pooled fund, but instead into supporting the national capacities to negotiate, plan and manage direct budget support through separate project support, then country-level negotiations will determine if UNDP can still be a 'signatory without fiduciary obligation' to a national sector budget support fund or pooled fund agreement (the 'agreement', hereinafter, refers to the government/donor/implementing partner common agreement signed by all involved; it is sometimes also called the 'direct budget support memorandum of understanding' or 'multi-donor budgetary support programme' or 'pooled fund agreement' for a given programme, in different country contexts). An exception would be written into the agreement as a non-fund provider, or UNDP could remain as a non-signatory with observer status in the direct budget support partnership group.

18. The UNDP project document would be an annex to the agreement, thus becoming an integral part of the agreement that recognizes the capacity development and oversight roles of UNDP as part of the partnership, without UNDP carrying the fiduciary obligations of the direct budget support fund providers.

19. If UNDP is requested by government to manage a pooled fund in a transition period, to strengthen national capacities in the given area, that would be done under existing UNDP direct execution guidelines and UNDP cost-sharing agreements. The standard UNDP management agent fee of 7 per cent would apply.

20. If UNDP can support national capacity development in a direct budget support environment by being an integral part of, but not a financial contributor to, the agreement, that is, a 'signatory without fiduciary obligation', that would be a preferred option. However, where this is not possible, UNDP would consider making its financial contribution to a sector budget support or pooled fund under the specific conditions given below.

21. If UNDP support is provided through the channeling of financial resources to a sector budget support or pooled fund, together referred to hereafter as the 'fund', all of the following conditions must be present:

(a) The modality of UNDP support is based on the official request of the government;

(b) The fund-supported development programme is in one of the UNDP mandate areas, as specified in the country programme and country programme action plan;

(c) There is a strategic imperative, whereby the financial contribution can play a catalytic function and strengthen the advocacy and capacity development role of UNDP in this area;

(d) There is unequivocal demand for the value-added role of UNDP in capacity development through technical expertise or advocacy, or as trusted facilitator, rather than for our financial assistance alone;

(e) There is clear indication that only a financial contribution will make it possible for UNDP to participate within the group of participating partners;

(f) In the case of sector budget support, the fund manager must be a government entity; and the contribution is subject to the national regulatory framework, including regarding allocation, procurement, audit, and accounting systems (provided such national systems are consistent with the principles of the Financial Regulations and Rules of UNDP);

(g) In the case of a non-UNDP managed pooled fund, UNDP would only contribute if the fund manager was a United Nations fund, programme or specialized agency; the contribution is subject to the terms of the agreement among the participants to the pooled fund, including with respect to reporting, monitoring, audit and accounting systems;

(h) The results management, audit, and monitoring and evaluation requirements, as agreed to by all the participating parties to the fund, do not contradict the principles and standards of UNDP;

(i) Adequate capacity exists with the fund manager (or 'implementing partner') to manage the fund; and

(j) There is a credible commitment to national capacity improvements in national systems for management, finance and oversight, where these may be lacking.

22. Where UNDP provides a financial contribution to the fund, such support is provided on the basis of a modified national execution/implementation modality. The project document would specify the implementation arrangements and the modified results framework, reporting, auditing, and monitoring and evaluation arrangements, as agreed with all the fund partners and in accordance with the agreement concluded among the participants. This would be annexed to the UNDP project document.

23. In addition, UNDP agreements with programme country government or third-party contributors for the purpose of support to the fund would be adapted to take into account the modified reporting, auditing, and monitoring and evaluation arrangements in line with the agreement. The agreement would specify that a copy of the audit assurance letter will be provided to all participating partners.

24. UNDP financial contribution caps are as follows:

(a) If funds come from UNDP *regular* resources: annual financial contributions towards sector budget support or pooled funds should not exceed 10 per cent of the annual authorized spending limit of core funds in the resource planning framework. To go above the standard cap, approval by the Executive Board at the level of the country programme document, as well as approval by the Associate Administrator at the level of the project, would be needed.

(b) If funds come from *other* ('non-core') resources: No limit or cap on the volume of funding channeled through UNDP is established. Each donor agreement will specify the terms and conditions as consistent with the common agreement.

25. Once a decision is made for UNDP to participate through direct financial contributions to the fund, the following checklist of UNDP procedural requirements must be complied with (see box 1).

Box 1. Checklist of UNDP requirements for direct financial contributions

1. Prior to entering into the agreement, UNDP will evaluate the risk assessment and assurance framework, together with the government and other donors, in order to ensure that the principles of the UNDP Financial Regulations and Rules are applied. This will be done using the common macro assessment tool as agreed to and used by all participating partners. Only if this is not adequate will UNDP conduct supplemental assessment activities.

2. The modified auditing and reporting framework as set out in the agreement does not contradict the principles of UNDP Financial Regulations and Rules, policies and procedures.

3. The fund is set up and managed in a results-based manner. This includes a clear results and resources framework related to the national development results to be achieved. In addition, a clear definition of roles and accountabilities of the government, UNDP and donors to the sector budget support/pooled fund must be provided

4. The agreement should reflect the principles of UNDP finance and accountability policies in the following direct budget support procedures: (a) joint assessment of the fund results; (b) clear mechanisms for joint monitoring and joint evaluation of progress and results; (c) reporting on the fund; and (d) combined audit of the fund results.

5. UNDP is not requesting separate UNDP-specific monitoring and reporting. However, where the above policies and procedures are not adequately reflected or do not meet the minimum UNDP standards, a UNDP-specific clause will be added to the agreement.

6. The current financial, administrative and management capacity of the national executing entity must be assessed and specific capacity development measures defined (micro-assessment, using the harmonized cash transfer and/or the UNDP capacity assessment methodology, or another agreed common methodology as used by the participating partners). Where the programme country government is the implementing agent, both macro-[1] and micro[2]-assessments are required.

7. In the case of the fund being managed by another United Nations entity, the arrangements would be consistent with the UNDG joint programming guidelines.

8. A duly signed project document – modified to adhere to direct budget support and pooled fund procedures and requirements as set forth in this document – is required, to which the agreement is annexed. The project document specifies the modified results framework, reporting, and auditing, as well as monitoring and evaluation requirements.

9. UNDP financial contributions to the fund require formal approval by the Associate Administrator or his designate, irrespective of the amount and source of funds.

10. A robust monitoring and quality assurance capacity would be required in country offices, to keep abreast of, and fully participate in, the development results monitoring and review process, given the combined nature of results in this context.

[1] *Macro-assessment.* In order to ensure adequate awareness of the public financial management environment within which organizations will provide cash transfers to implementing partners, a review of existing assessments of the public financial management system will be conducted. This review is expected to be undertaken once per programme cycle, preferably during the preparation of the common country assessment, and may be updated whenever significant changes in the governance system of the country are noticed. The macro-assessment findings provide information on the national context that is useful for each micro-assessment. The findings related to the national audit system establish whether the audit system can be relied on to conduct the required audits of implementing partners that receive cash transfers.

[2] *Micro-assessment* assesses the risks related to cash transfers to the partner and is done once in every programme cycle, or whenever a significant change in the implementing partner's organizational management is noticed. Assessments should be done for partners (government or NGO) that receive or are expected to receive cash transfers above an annual amount (usually $100,000 combined from all organizations; as initially defined in the country programme action plan or annual work plans, or as locally agreed among the organizations). For implementing partners with planned annual cash receipts below the $100,000 threshold, assessments *may* be conducted if so desired by the organizations involved to determine the most effective and efficient procedures.

IV. Next steps for Executive Board consideration

26. It is proposed that the Board consider the new cycle, 2008-2011, as a pilot period for UNDP to assume an enhanced role in the direct budget support environment that includes the ability to contribute to a government-managed sector budget support fund, or a United Nations fund, programme or specialized agency-managed pooled fund, in a given number of demonstration countries.

27. This would require the addition of financial regulations specific to direct budget support and pooled funds, and would be an amended version of financial regulation 18.05, to allow for reporting on co-mingled funds; 16.04, to allow for fund-level auditing in accordance the with agreement of the participants to the fund; and definitions for direct budget support, sector budget support and pooled funds. The wording of such an additional regulation would be as set out in the annex to the present report.

28. UNDP would monitor the pilots in the select countries carefully, with benchmarks as agreed against the conditions set for UNDP entry into the fund. For example:

(a) Has it enhanced the impact of UNDP policy and capacity development contributions?

(b) Have there been measurable increases in investments in capacity development, and national priority given to it, in the areas of direct budget support and pooled fund engagement?

(c) What has been the impact on relations with government and donor partners, including with the national aid coordination mechanism?

(d) Is the harmonized cash transfer or an other agreed capacity assessment instrument being used, and are these results being monitored with regard to improvements in national programme and financial management and monitoring capacities?

29. It is suggested that the results of such would be reported to the Executive Board at the end of the pilot period, and that the financial report on contributions to direct budget support and pooled funds would be included in the annual review of the financial situation.

30. UNDP would use this process to facilitate a common approach for engagement in direct budget support and pooled funds among the UNDG over the course of 2008. This effort would be framed by the UNDG position statement on capacity development (2006), and the results of this pilot period would provide country-based experience and learning to facilitate and position the work.

31. The interim results would also be used in the national and intergovernmental discussions leading up to the Third High-Level Forum on Aid Effectiveness, to be held in Accra, Ghana, from 2 to 4 September 2008.

Annex
Proposed amendments to the Financial Regulations and Rules

Note: Text in italics indicates proposed amendments to the regulations.

Regulation 18.05

(a) Each executing entity or, under the harmonized operational modalities, implementing partners, shall maintain such accounts and records as are necessary to enable it to report on the financial status of funds obtained from or through UNDP, including in particular the balance of recorded allocations, expenditures and commitments, *except in the case of direct budget support and pooled funds.*

(b) *The Administrator shall establish the policies and procedures for UNDP participation in direct budget support and pooled funds, which shall provide for UNDP reporting on the financial status of funds obtained from or through UNDP based on the totality of co-mingled resources contributed to the sector budget support or pooled fund, on the basis of programme and financial reporting established in the agreement among the participants to, and governing, the sector budget support or pooled fund. The expenditure recognition for UNDP resources contributed to the sector budget support or pooled fund shall be on a prorated basis.*

Regulation 16.04

(a) The Administrator shall ensure that, except for organizations of the United Nations system, executing entities shall require auditors to follow the audit principles and procedures prescribed for the United Nations in respect of resources obtained from or through UNDP and shall ensure that each UNDP programme activity is audited at least once in its lifetime, or as otherwise required pursuant to the relevant agreements governing such programme activity, *except in the case of direct budget support and pooled funds.*

(b) *In the case of direct budget support or pooled funds, resources obtained from or through UNDP shall be audited in accordance with the audit provisions established in the agreement among the participants to, and governing, the direct budget support or pooled fund, consistent with the policies and procedures for UNDP participation in direct budget support and pooled funds, established by the Administrator.*

Regulation 27.01

(a) ***Direct budget support*** *is defined as a method of financing the budget of a partner country through a transfer of resources from an external financing agency to the national treasury of the partner government. The funds thus transferred are managed in accordance with the recipient's budgetary procedures. This includes using the national regulatory framework for financial allocations, procurement and accounting systems.* ***Sector budget support fund*** *shall refer to the financial contribution to a government budget, managed in a national account by a government entity for a specific set of sector or programme results. A* ***pooled fund*** *is designed for financing expenditures within a sector or a programme through the pooling of the financial resources by the participating partners. A pooled fund would be contracted out by government to be managed by an agreed party.*

(b) The contribution of UNDP to the sector budget support or pooled fund is co-mingled with other funds. In the case of a contribution to the sector budget support fund, the contribution is subject to the national regulatory framework, including with respect to allocation, procurement, audit, and accounting systems, provided such national systems are consistent with the principles of the Financial Regulations and Rules of UNDP. UNDP will make a financial contribution to a sector budget support fund only on the basis of a satisfactory capacity assessment of the national partner responsible for management of the sector budget support fund, by the participants in the sector budget support fund, including with respect to reporting, monitoring, audit and accounting systems. In the case of a pooled fund, the contribution is subject to the terms of the agreement among the participants to the pooled fund, including with respect to its reporting, monitoring, audit and accounting systems.